Knowledge Statement

Knowledge of Commercial, Economic, and Political Risks of Buyer and Buyer's Country

Goal

The goal of this material is to introduce you to the concepts of commercial, economic and political risks found in a buyer's country, including understanding these risks and their effect on timely payment and financing international transactions.

Learning Objective

You will be able to:

- identify commercial risk and its impact on timely payment of international transactions.
- identify economic risk and its impact on timely payment of international transactions.
- identify political risk and its impact on timely payment of international transactions.

Introduction

An international manager needs to avoid the main pitfalls of country risk assessment by looking for information in a variety of places, conducting relevant analysis, and changing opinions if necessary. A company must set acceptable risk objectives based on its reward goals and risk tolerance. The key to reducing risk is a thorough assessment of the country and customers. Maintaining a systematic approach for each customer and country in this analysis will assure that each evaluation is consistent, relevant, and objective.

Ensuring Timely Payment

One approach to country risk assessment is to use "CAMEL" to analyze:

- Capital Adequacy = financial status based on a country's balance of payments
- Asset Quality = economic and financial strength based on a country's combined natural, human, and general economic resources
- Management Quality = a government's fiscal, monetary, credit policies and politics and how well these are implemented

- Earnings Potential = internal and external variables that affect how well a country is achieving its capabilities
- Liquidity = a nation's foreign exchange cash flow prospects

To ensure timely payment, an international manager needs to determine what the risk really is. These determining factors come in various forms:

- non-payment
- late payment
- currency devaluation
- import restrictions
- bank problems
- government issues
- debt chains
- tariff changes
- shipping difficulties
- pilferage

When measuring risk to determine how prompt payments can result, an international manager should attempt to put real values on the potential loss. These will have to include the absolute cost in cash terms and the cost in relation to the anticipated profit/loss. The company's risk tolerance (established by the credit management policy) will have to be taken into consideration as well the company's specific objectives in a given country, since the goal of "maximum market penetration," for instance, will point to different defensive measures than an objective that reads "maximum cash flow."

A check of the possible options for mitigating risk will reveal a number of possibilities, which need to be evaluated for anticipated benefits and costs. Alternatives could be:

- agreement to open account terms
- insistence on draft terms
- unconfirmed L/C
- confirmed L/C
- insurance

- arranging payment from an account the importer has abroad
- forfeiting/Factoring
- cash in advance
- refusal to ship

Because of the different way in which international markets now finance themselves and the implications such have for a risk to a seller, the following questions should be asked in the normal assessment of variables that determine country risk:

- Does the country have a fixed exchange rate and free movement of international capital?
- Is the exchange rate overvalued or widely deemed to be?
- Has a country with similar characteristics recently experienced a currency crisis?
- Is there a large budget deficit and much government debt outstanding, especially short-term, needing constant rollovers at rising interest rates?
- Is there loose monetary policy and high inflation?
- Is the domestic economy in, or at risk of, recession?
- Is there a large current-account balance-of-payments deficit?
- Is there an asset-price boom, especially a credit-driven one, occurring?
- Is there a large volume of bad debt in the banking sector, coupled with a poor system of bank supervision?
- Has there been a lot of unhedged foreign currency borrowing?
- Are accounting standards poor, with few disclosures requirements, ambiguous bankruptcy proceedings, etc.?
- Is there socio-political uncertainty?

Facilitating External Financing

To understand the risks of external financing, the following questions need to be asked:

- What is external financing?
- How can it be viewed and understood?

- How does CAMEL play a role in external financing as it has been described above?
- What are the issues and factors that need to be considered when determining external financing?

The answers can be grouped by both commercial and political risk categories as discussed below.

Commercial Credit Risk

- Nature of the business
- Financial strength of the buyer
- Nature of the relationship with the buyer--new buyer or a frequent customer, dealer/distributor, or a subsidiary/affiliate
- Buyer's record of meeting local and international payment obligations
- Ownership of buyer, private or public sector
- Potential loss if shipment is not accepted:
    - value of the shipment (marginal pricing concept--cash invested in the goods, high or low profit at the margin)
    - types of goods , perishable or specially manufactured where total loss might result if shipment were refused
    - likelihood of shipment being refused-- a change in market conditions for commodity shipments may induce buyer to refuse shipment).

Sources of information to help companies identify commercial credit risk are:

- credit reports from independent agencies, banks, etc.
- customer-supplied financial data
- industry intelligence

Political Risks

- Political conditions in buyer's country
- Stability of the local, state and federal governments
- Possibility of import license cancellation, or other unexpected actions that would result in the non-acceptance of the shipment
- Possibility of coup, civil disturbance, etc.

- Possibility of change in foreign exchange regulations that could delay or disrupt payment

Economic Risks

- Economic conditions in buyer's country including expected and recent changes
- Economic trends-- inflationary, recessionary, etc.
- Currency exchange control regulations
- Currency flow regulations
- Country's balance of payments

Sources of information to help companies identify political and economic risks are government and private agency intelligence reports including the following:

- Chase World Guide for Exporters
- Chase Econometrics Country Reports
- International Monetary Fund Data
- World Bank Data
- CIA World Fact Book
- US Department of Commerce – Country Commercial Guides
- US State Department – Country Reports

Summary

After completing this lesson, you should be able to describe the ways to ensure timely payment and both the economic and political risks factors that influence payment results. Included in the ability to recognize the ways risk factors influence payment is knowing when alternative means of financing need to be considered.

Resources

Association of Executes in Finance, Credit & International Business (FCIB) – www.fcibglobal.com

Chase Publications – www.chase.com (see World Guide for Exporters & Chase Econometrics Country Reports)

International Monetary Fund Data – www.imf.org

World Bank Data – www.worldbank.org

The CIA World Fact Book – www.cia.gov

US Department of Commerce – Country Commercial Guides – www.export.gov

US State Department – Country Reports - www.state.gov